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STATE PLEASE PASS TO USTDA

E.O. 12958: N/A
TAGS: PGOV PREL ECON EINV EPET SOCI RS KZ
SUBJECT: KAZAKHSTAN: BEHIND THE SCENES OF KARACHAGANAK AND KASHAGAN

REF: (A) 08 ASTANA 2449
(B) 08 ASTANA 1646
(C) 09 ASTANA 0041
(D) 09 ASTANA 0352

ASTANA 00000061 001.3 OF 004

¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: For more than 90 minutes on January 20, Maksat Idenov, First Vice President of national oil company KazMunaiGas (KMG), briefed the Ambassador on the ongoing dispute between shareholders in the Karachaganak Petroleum Operating Company (KPO) and KMG. In September 2009, KPO filed a claim at an international arbitration court in Stockholm for $1.4 billion for reimbursement of crude export duty payments. Speaking without notes -- but with passion and conviction -- Idenov argued the government's case that KPO has not provided sufficient justification or supporting documentation for major expenditures since 2003. He said the government has filed a counter-claim for $3 billion. Unable to reach agreement at the level of corporate senior executive vice president, Idenov stated that the parties have begun talks at the level of corporate CEO. The case is scheduled to go to arbitration on March 21. Idenov also summarized budget negotiations for the massive, $150 billion Kashagan oil-exploration project. In both cases, Idenov underlined that he only is asking international companies to follow fundamental principles of good business management. END SUMMARY.

BACKGROUND ON KARACHAGANAK

¶3. (U) KPO comprises Britain's BG Group (32.5%), Italy's ENI (32.5%), Chevron (20%), and Russia's Lukoil (15%). One of the largest oil and gas condensate fields in the world, with reserves estimated at 1.2 billion tons of oil and 1.34 trillion cubic meters of gas, it is the only significant oil exploration project in Kazakhstan in which KMG does not have an equity stake (ref A).

¶4. (U) On September 18, 2009, Bloomberg reported that BG Group, as the lead operator, initiated arbitration proceedings to seek

reimbursement of $1 billion for oil export customs duty payments made from June 2008-January 26, 2009, when the government lowered the crude export duty to zero (ref B). On December 29, 2009, Prime Minister Karim Masimov told reporters that Kazakhstan wants to join the Karachaganak project as an equity partner, reportedly with a 10% stake. (NOTE: According to Idenov, the consortium claims $1.4 billion while the government had filed a counter-claim for more than $3 billion. When asked to comment on reports that KMG has requested 10% of KPO, Idenov confirmed Masimov's statement, but concluded, "You never know how an arbitration case will play out." END NOTE).

IDENOV IN THE LEAD

¶5. (SBU) Contrary to reports from ExxonMobil, which is not a member of the KPO consortium, Idenov has retained the Karachangank portfolio and is the government's lead negotiator on the dispute (ref C). He told the Ambassador that he met in London on January 11 with executive vice presidents from the KPO shareholders, but they were unable to reach an accord. As a result, Idenov said he will appeal to the companies' CEOs in an attempt to resolve the dispute. He implied that both sides are working in good faith to reach a negotiated settlement before the case goes to an international arbitration court in Stockholm on March 21.

SHOW ME THE RECEIPTS

¶6. (SBU) Idenov told the Ambassador that KPO has submitted requests for reimbursement of hundreds of millions of dollars in expenses from 2003-2008, without proper justification or supporting documentation. Launching into his brief, he jumped to a white board and began to make his case in graphic detail without the aid of notes. According to Idenov, KMG retained the audit firm KPMG to

review KPO's 2003-2006 statements and discovered that KMG reimbursed KPO for $697 million during that period, without proper supporting documentation. He also asserted that the audit firm Ernst and Young reviewed KPO's statements from 2007-2008 and could not justify $347 million in expenses. Idenov told the Ambassador that when he presented this information to KPO executives, they replied, "All right, Maksat, we'll write you a check for that amount and just recover those costs later." Idenov said he refused to do business that way, and would pursue the matter further.

HIGH STAKES

¶7. (SBU) Idenov described in detail several situations dating to 2002, where -- in his opinion -- KPO management made unwise decisions that cost KPO's shareholders dearly. (NOTE: Although KMG does not own equity in KPO, Idenov considers KMG, as the authorized agent of the Republic of Kazakhstan, a shareholder in the project. END NOTE.)

-- In 2002, he said that President Nazarbayev attended the inauguration of a major new gas processing plant. "There was a red ribbon and big scissors, and smiles all around," he described. One week later, according to Idenov, a gas leak due to poor quality welding forced the plant to shut down and evacuate employees. The plant remained idle for one year, "and the shareholders suffered," Idenov concluded.

-- Also in 2002, the Atyrau-Bolshoi Shagan pipeline became plugged by caustic soda, because KPO pumped unprocessed condensate through the pipeline. Idenov asserted that KPO cut off the damaged segments and rebuilt the pipeline at a cost of $600 million.

-- In 2006, KPO's "Train 4," a processing unit that separates gas from liquids, was estimated to cost $467 million to build. Idenov said he approved the expenditure, and then was told later that the project cost had escalated to more than $1 billion. "I understand that the cost of construction can increase with time," he explained , "but give me some justification!"

-- Idenov also mentioned KPO's $192 million purchase of new pipe racks for the project, which arrived before the cement foundation

was laid on the platform. As a result, the piperacks were stored outside, where they were punished by the severe climate of northern Kazakhstan, deteriorated, and were rendered useless.

-- In 2006, Idenov said he authorized KPO to spend $478 million for the front-end engineering design (FEED) of Phase III expansion activities. Once these funds were spent, he claimed, KPO requested another $300 million to fund a new design concept.

-- In 2008, Idenov approved a request for $450 million to procure high-technology material (called X-60) that would resist corrosion by sour gas. Later that year, KPO discovered that newer technology (called F-22) had come on the market, and requested another $480 million to acquire the new material, abandoning the previous material.

-- In 2009, according to Idenov, KPO submitted an annual budget for 2010 of $2.1 billion. Once Idenov reviewed the details, however, he said he could only find justification for $950 million.

IMMEDIATE CONSEQUENCES

¶8. (SBU) Once KPO was presented with these findings, Idenov stated, BG Group's Senior Vice President Mark Carns was immediately fired, and other senior executives barely escaped a similar fate. He asserted that BG Group's Peter Drunfield circulated an eight-page letter to Masimov and Samruk-Kazyna Deputy Chairman Timur Kulibayev, disputing Idenov's claims and asking for their support. However, they refused to respond, and the KPO partners declined to support Drunfield, who subsequently left BG Group. Idenov disclosed that

KMG and KPO are now deep in negotiations on these issues, and suggested that he would elevate the discussion to the level of corporate CEO. Idenov admitted that KMG also could provided better project oversight, and should have demanded the documents supporting KPO's expense claims years earlier.

FIGHTING FOR FUNDAMENTAL PRINCIPLES

¶9. (SBU) Idenov mentioned complaints by KPO member companies -- with the notable exception of Chevron -- that he is causing trouble and making unreasonable demands. "When they ask me, 'What are you fighting for?,' I tell them, 'Serve the shareholders honestly, and follow five simple business principles: Quality Decisions; Quality Health, Safety, Security and Environment; Quality Technical Integrity; Quality Project Management; and -- most importantly -- Quality Internal Controls. This is Kazakhstan's demand to KPO!'" (NOTE: Idenov thanked the Ambassador for his September 28, 2009, speech on corporate responsibility to the members of the American Chamber of Commerce. He contended that was the first time any Western ambassador has stressed publicly the theme in Kazakhstan. "It has made a huge difference," he said, "and will help U.S. companies, which set a good example for others." END NOTE).

AKSAI IN WONDERLAND

¶10. (SBU) Idenov highlighted KMG's demand that KPO's senior management staff move to Astana from London in order to provide proper oversight and supervision. He complained about KPO's expenditure of $482 million on salaries and overhead expenses in 2009, but just $320 million on oil and gas production services. "It's like Alice in Wonderland," he exclaimed. "They're making their own rules, just like the White Rabbit. You can start wherever you want, finish wherever you want, but there is one rule: everybody gets a prize. Everybody gets paid."

A DISSENTING VOICE

¶11. (SBU) In a private meeting on January 20, Alex Verba, chairman of Astana Law Partners LLP, strongly disputed the government's claims that KPO lacks supporting evidence for cost reimbursement. An auditor, Verba was a resident advisor on cost reimbursement issues to the Karachaganak project in Aksai from 2000-2005. He argued that the government is trying merely to counterbalance the legitimate claim of KPO for reimbursement of illegal crude export

duties. Verba claimed that KMG has never done a professional audit of the cost-reimbursable claims, and that they lack the expertise to do a proper audit. Verba also alleged that KMG has its own reasons for not conducting a full audit. "Their people were benefitting from these subcontracts, and other arrangements, for years," he claimed. Verba predicted that the government would lose its arbitration case. "They haven't won one yet," he underlined.

KASHAGAN'S 2010 BUDGET

¶12. (SBU) Having finished the litany of charges against Karachaganak, Idenov turned to Kashagan. He highlighted the government's significant concern about the project to hook up the drilling islands to the onshore processing plant, which is 30% behind schedule and well over budget. The initial tender won, he continued, with a bid of $196 million, but current costs have reached $443 million. The original 2010 budget for Kashagan of $10.5 billion was reduced to $8.2 billion after careful review by KMG (ref C), he stated. To illustrate, he told the Ambassador that the general director of the North Caspian Operating Company (NCOC), detailed from Total, is paying $22,000 per month for an apartment in Astana, and that other senior corporate executives are paying similar amounts. Idenov said he approved these expenses, but warned the executives that the amounts were excessive.

PHASE II UNDER REVIEW

¶13. (SBU) Idenov asserted that he agreed to Kashagan's Phase I budget of $38 billion, but has asked the consortium for supporting documentation and justification of planned expenditures. In addition, he has not approved the request for $15 billion to fund Kashagan's Phase II development ($3.2 billion in 2010, $5 billion in 2011, and $7 billion in 2012), "because they (Agip/ENI) are Italians. Because they messed up (on Phase I). Because I don't trust them. They scared all of us with their management of Phase I," he explained. Idenov expressed his preference for Phase II to first undergo FEED, which would enable the consortium to develop a more accurate and realistic project plan, but the partners protested. According to Idenov, they said, "No! Give us the $15 billion and let's go!" Idenov claimed he merely was trying to protect them from the Financial Police, who would likely launch an investigation into the project if large investments could not be justified. Idenov also invited the Ambassador to send a representative to the next Kashagan budget meeting, claiming he had nothing to hide. He even speculated that the private-sector partners would protest this unusual display of transparency.

IDENOV'S FUTURE

¶14. (SBU) As the meeting came to a close, Idenov indicated that he had received job offers from Shell (where he used to be a Vice President for Strategic Planning), Agip, and Statoil. Idenov dismissed these offers, saying it was just a way for the companies to remove an obstacle in their way. "I'm not going away that easily," he asserted. "But if the gentleman on the wall (Nazarbayev) says we shouldn't follow these five fundamental principles, then I will know that times have changed, and I will start to consider my options."

¶15. (SBU) COMMENT: Maksat Idenov possesses a large and lively personality. He clearly has critics in the government -- witness his shrinking portfolio -- and among the international oil companies. However, it is hard to argue with his basic business principles, and reasonable to expect that projects as complex, costly, and critical as Karachaganak and Kashagan could be managed more efficiently. Nevertheless, we hope that in both cases, the parties are able to reach accommodation without resort to legal action. END COMMENT.

HOAGLAND